

To: David Freeman

From: Barbara Hale

Date: September 18, 2002

Re: Hale Comments on Freeman Assumptions on Level of Adequate Reserves

I appreciate your following up the Power Authority hearing on September 6 with this effort to draw out some common understanding. Below are my personal, informal comments, which I offer without committing my agency to any point of view on the subject, as you suggested. I agree that getting the professionals in agreement on the appropriate assumptions underlying setting a reserve level will help advance our agencies efforts. As you know, the PUC policy statements on matters come in the form of formally adopted decisions, and I appreciate that the Power Authority and CEC are active participants in the Procurement Rulemaking where parties are vetting views on this issue. It is in that venue that the PUC is developing a record on which to base its view.

Some general comments:

I think we need to get on the same page as to the underlying objective in setting reserves. I do not agree that the objective is to “engender competition” or to set reserves for “economic purposes.” Both of these perspectives were expressed at the hearing, and are embedded in some of these assumptions. As we discussed at the hearing, “piling on” capacity for these purposes will put upward pressure on retail rates. I think the state’s electricity market will remain a hybrid – characterized by both reliance on competitive influences and infrastructure development and traditional regulation of integrated (i.e. generators and distributors) investor-owned utilities.

Specific Reactions to your Proposed Assumptions:

1. Agree: **Reserves must be the responsibility of the load serving entities (LSE)**
-- and the regulatory agencies responsible for their oversight, such as the CPUC and local government in the case of municipalities.

- 1a. Focus of the ISO should be solely on operating the system in real-time. This comment is consistent with the Interagency Working Group comments to ISO in its MD02 proceeding.

2. Don’t Agree: **Reserves must be from identified power plants or demand reserve programs.**
 - Existing DWR Contracts do not specify delivery sources
 - Depending upon terms, contracts without specified sources can still be reliable (i.e. very large liquidated damage provisions for non-performance.)
 - Ignores probabilistic determination of reserves. For example, a portfolio of contracts with “unidentified power plants” can still

provide reliability -- i.e. 5 50 MW contracts each of which is 50% reliable based on historical data may not provide 250 MW of reserves but may provide 100 MW or some de-rated amount.

- Requiring “identified” demand reserve programs as being the only programs that count creates difficulties in including the impact of dynamic and real-time pricing programs in reserve levels. Proposed treatment skews demand programs toward “hard-wired” traditional interruptible programs and may undermine consideration of other programs (under consideration in PUC Demand Response Rulemaking, for example, which Power Authority and CEC principals have participated in.)

3. Don’t Agree: The LSE must have a firm contract right to call on the reserves when needed.

- Ignores the use of economic incentives to ensure availability absent any firm contract rights
- Applying this criteria excludes almost all QF capacity (which has no obligation to deliver but does because it has a strong economic incentive to do so¹) as well as many DWR contracts

4. Maybe: Power plants that are not under firm contract to California LSE’s shall not be counted as part of our reserves.

- Depends upon the form of the final market design rules such as “must-offer” requirements;
- Right of California to eliminate exports to meet demand (allowed but never utilized by the ISO, to my knowledge)
- Rules regarding sales of excess energy by in-state municipals

**5. Maybe: Adequate level of reserves are made up of two elements:
- Reliability reserves and
-“Market Control” reserves (or planning reserves)**

6. Don’t Agree: Reserves needed for reliability purposes shall be a percentage of net dependable capacity minus forced outages.

- The purpose of reserves is to take into account the possibility of forced outages. As written this could result in double-counting the need for reserves.

To correct for this concern, I suggest modifying your assumption to include the underlined text read:

Reserves needed for reliability purposes shall include ancillary service requirements plus additional reserves based on a percentage of net dependable capacity minus forced outages.

¹ For example, the ISO takes available QF capacity into account when determining RMR needs

7. Partially Agree: **Additional reserves needed to assure a competitive market depend on the per cent the spot market is of the entire load. If advance contracts cover 95% or more these reserves can be small. If the near time market is larger these reserves must be sizeable.**
- There is a cost-benefit tradeoff inherent in this statement that needs to be analyzed. Begs the question: “If we need excessive level of reserves to ensure a competitive marketplace, than are the benefits of competition worth the cost of achieving it?” I come at this issue from the perspective that the impetus for California embarking on deregulation was to bring retail rates down.
 - This statement is dependent upon the final market rules adopted by FERC and the ISO.
 - Resolution of “must-offer” requirements, level of the price cap, and the like, will determine how much, if any, additional capacity is needed to minimize total costs
 - Relative exposure of various market participants to the spot market raises equity issues associated with the level of reserves (i.e. market participants who are long in the market (more capacity than load) would not derive any benefit paying for additional reserves since it would not affect their energy prices.)

cc: Kellan Fluckiger, CPA
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